The Key Lesson To Be Learned From Trump's Tax Returns: A Response To The NY Times

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(Updated January 3 and 4, 2023)

The NY Times recently published an analysis relating to the key takeaways from Trump's tax returns. The story highlights several items that were not specifically addressed by the House Ways and Means committee and the Joint Committee on Taxation relating to the publicly disclosed Trump tax returns.

The examination and evaluation of tax returns, based on over 40 years of experience in this area of law, requires an examination of a number of agreements (such as partnership agreements) and contracts which Trump entered into and which are not part of the tax return submitted to the IRS. Also required as well is substantiation and making inquiry regarding the purpose and amount of Trump's various claimed expenditures. Taking the word of his return preparers and advisors is just not sufficient-far from it. Without doing that, any opinion on the bona fides of those returns or any item on it is mere guesswork. Interesting to read but that is about it.

In addition to examining the underlying Trump contracts and agreements, items incurred and taken into account in years prior to the period being examined may also have to be reviewed for relevance in how they could impact the returns under review (such as NOL and tax credit carryovers in prior years).

Practicing in tax law involves the evaluation of the merits of many positions' taxpayers would like to take to reduce their taxes. That is no secret. It is also true that some positions taxpayers would like to take range from being very aggressive to standard positions on various issues. In our system of hoped for voluntary compliance, it is basically left up to tax lawyers and CPAs, as well as other tax advisors (such as regular tax return preparers), to police the behavior of taxpayers to keep the tax system in check.

In evaluating Trump's tax returns, there are some who have or will assert that fraud has occurred. That might have happened but I do not think there is any way of establishing that fraud has occurred without doing the kind of evaluation noted earlier.

The reason why Trump, and other taxpayers like him, showed losses or zero income for a number of years is that the current federal income tax code is slanted toward providing tax benefits for those who add capital to the economy, meaning rich individuals (called high net

worth in the trade) and large corporations. Wage earners and the self-employed are provided fewer tax benefits and in smaller amounts.

Real estate has enjoyed favored treatment under the federal income tax code for many years. Borrowed money with no personal liability for repayment (known as non-recourse loans) is treated as the capital of the real estate owner and entrepreneur whereas other taxpayers outside of real estate are provided much less favorable treatment for borrowed money. This increase in capital goes into the amount treated as the purchase price of the real estate and this allows for increased depreciation and interest deductions for the taxpayer-owner. That needs to change.

To make matters even less fair, the reason why non-recourse real estate loans are treated as capital is that some day in the future when the loan is either repaid or cancelled, offsetting income to the taxpayer is supposed to occur. This is known in the trade as recapture. The problem here is that many taxpayers do not report recapture events, or the taxpayer dies before the loan is paid or cancelled. In that case, current law would permanently forgive that amount and there will be no recapture-ever. That also needs to change.

According to feedback from inside the IRS, a significant portion of tax abuse occurs because of the partnership tax rules of the internal revenue code which also greatly favor the very rich and large corporate taxpayers. Prior proposals from Senator Wyden would attack those abuses. That effort should be supported by anyone serious about meaningful tax reform.

Not making any excuses for Trump, who may or may not have abused the tax system to his advantage, but the current tax code allows for such abuses.

The key takeaway from all of this is that the current tax code needs to be reformed to be fairer to those who provide labor as compared to those who provide capital. In addition, the favorable rules for real estate capital need to be more limited in scope and the rules for labor need to be elevated in terms of tax benefits provided.

Also required is that the IRS must audit many more high-income individuals and corporate taxpayers, specifically including those partnerships whose partners are those very same individuals and corporations. The former IRS commissioner was quoted as saying that the IRS is outgunned when it comes to challenging the tax positions of these individuals and corporations who are represented by the very large U.S. based international accounting firms (known as the Big 4), as well as by the large law firms. That also needs to change and there must be more efficient audits of those taxpayer capital providers.

Some General Observations On Just ReleasedTrump Tax Returns

December 29, 2022

(Updated December 30 and 31, 2022)

Based on the latest information, the public disclosure of the Trump tax returns by the House Ways and Means committee was scheduled for and actually occurred on December 30, given that the new congress will commence the first working day (Tuesday, January 3) after the long weekend. See Ways and Means release.

In light of the pending release, I offer up the following comments. I am not going to comment on specifics of the Trump audit given that audit recommendations in this case have already been made by the Joint Committee on Taxation to the House Ways and Means committee, and there will be many others who will offer their views on this specific audit.

1. There is the typical net operating losses (NOLs) which tie into depreciation deductions previously claimed. The use of non-recourse debt in the real estate industry can boost the amount of losses that are allowed under the Internal Revenue Code (IRC) but the use of those losses with non-recourse debt basis is supposed to be recaptured when the debt is paid off, cancelled, etc. At that point, liabilities on the property will exceed existing tax basis.

2. The elective deferral of certain debt reacquisition income in 2009 and 2010 (IRC section 108(i)) is supposed to be recaptured in the 2014–2018 period ratably (for a deferral from the 2009 year) or the 2014–2018 period for the 2010 tax year. This was a one-time explicit deferral of cancellation of indebtedness (COD) income.

3. If you can borrow to refinance current debt, you can defer recapture in many cases where liabilities exceed tax basis at that time. Current law may allow forgiveness at death of liabilities in excess of basis, although this is not perfectly clear. See Tax Notes article. The so-called value equals basis rule under the section 704(b) regulations also allows for the early special allocation of depreciation with a gain chargeback later. Absent this special rule, the special allocation of tax depreciation would not be allowed.

4. There are two principal IRC sections that could disallow these NOL losses from being deducted currently, but both of them have exceptions for the real estate industry, as does the value equals basis rule under the 704(b) regulations.

5. Section 465 limits the losses from certain activities and thus ordinarily non-recourse debt could not be used to create more loss because of this statute. Only recourse debt would have been allowed to increase the amount at risk. But the statute allows an exception for certain qualified non-recourse financing. See IRC section 465(b)(6) (which allows this debt financing if the property is in connection with the activity of holding real property and certain other conditions apply, mainly that the loan is nonrecourse to the owner and is arm's length and commercially reasonable). It would not be uncommon for this exception to be used to allow non-recourse debt of real estate owners to increase the NOL.

6. Another potential exception to current loss allowance is the passive loss rules of section 469. But those rules typically block the offset of passive rental income by losses or other deductions. The statute here allows an offset to rental income for qualified real estate professionals in some cases. See section 469(c)(7). It would not be uncommon to see this exception being used as well for real estate owners.

7. There is a possible attack on the conservation easement deduction under section 170 mentioned in the press either using the deemed sale rule of section 704(c)(1)(B), or looking at the correctness of the valuations or the technical details of the deed. If there was no challenge to the charitable deduction that was apparently claimed, it likely should be examined if the statute of limitations permits, just as other easement transactions have been examined by the IRS.

8. The structure of the Trump group of entities as described in the House report shows a fairly typical structure to greatly minimize the imposition of self-employment tax. The current president did some of the same with an S corporation. The issue comes down to the application of the SE tax to LLC or LP members or to S corporations. This is a known issue. There are proposed regulations that would fix this from the late 90s but the IRS has refused to finalize those regulations, instead waiting for Congress to change the law. Cases will be challenged in court by the IRS but no final regulations. See Tax Notes story. This problem is very pervasive.

9. Unreimbursed expenses need to be substantiated and its connection to business or investment activity looked into.

10. Congress has favored the real estate industry over the years to be sure. What now? Changing these favorable tax benefits that are generally applicable to real estate owners would be difficult given the real estate lobby. There would be a significant debate where those who advocate eliminating benefits for the very wealthy would clash with those who advocate that damage to the economy would otherwise result. We'll see what happens. Much more interesting to me is the potential for future law change, including legislating relating to presidential audits and real estate tax benefits generally, as compared to this particular taxpayer.

Conservation Easement Charitable Deduction Restriction In Omnibus Bill Becomes Law

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(Updated from December 20, 23 and 29)

On December 20, 2022, the easement conservation disallowance provision of proposed section 170(h)(7) was added by the Senate as section 605 of Division T (the Secure 2.0 title) to H.R. 2617, the omnibus consolidation bill. Section 605 of the bill, as did section 1104 of S.4808, the prior proposal on this subject, contains a prohibition on charitable donations in kind of conservation easements by partnerships (and other passthrough entities) if the donation does not meet the requirements in the new statute. The ***Consolidated Appropriations Act, 2023***, was sent to the president's desk for signature on December 23, 2022. See Tax Notes story, and White House statement. The bill was signed into law on December 29, 2022.

Section 170(h)(7) will be added to provide that a contribution by a partnership (whether directly or as a distributive share of a contribution of another partnership) is not treated as a qualified conservation contribution (and thus not deductible under section 170) if the amount of such contribution exceeds 2.5 times the sum of each partner's "relevant basis" in such partnership. (Proposed listing notice regulations, REG-106134–22, Dec. 8, 2022, would define the 2.5 times limitation in terms of "investment", an undefined term. These proposed regulations will need to be conformed to the new statute if and when enacted into law. See Tax Notes story. This new rule has a cliff effect in that even one penny above the 2.5 times limitation will cause the disallowance of the entire deduction.

For this purpose, the term "relevant basis" means, with respect to any partner, the portion of such partner's modified basis in the partnership which is allocable (under rules similar to the rules of section 755) to the portion of the real property with respect to which the contribution is made. And the term "modified basis" is defined to mean, with respect to any partner, the partner's adjusted basis in the partnership as determine by the partnership after taking into account certain adjustments as provided by the IRS in guidance, specifically not including section 752 liabilities in modified basis. There is an exception for contributions made directly or indirectly outside of a 3-year holding period. There is also an exception for contributions made by certain so-called family partnerships.

There are to be regulations or other guidance relating to reporting of the contribution to the IRS and to prevent avoidance of the new rules.

The Omnibus bill adds an exception to the disallowance rule of new section 170(h)(7) for contributions to preserve certified historic structures unless, as provided in new section 170(f)(19), certain disclosure requirements (such as including on form 1065) are not met. Section 170(h)(7) would be applicable on a prospective basis from the bill's enactment date with caveats of no inference for other situations.

The Omnibus bill at section 605(d) would also add a safe harbor to be issued within 120 days of the date of enactment of the bill (by April 28, 2023) to provide for corrective deeds, within 90 days of issuance of that guidance (by July 27, 2023), relating to extinguishment clauses and boundary line adjustments. However, the safe harbor is not to apply if the transaction is one described as a reportable transaction under section 6707A(c) or is a transaction described in IRS Notice 2017–10, relating to syndicated conservation easements or is in litigation or where a penalty relating to the contribution has been finally determined. This reference to the IRS notice could be viewed as Congressional disapproval of the case law that has required these listing notices to be subject to public comment under the Administrative Procedure Act (See IRS Asks Tax Court to Reconsider Decision Holding Notice Invalid, Tax Notes story, and see the Mann Sixth Circuit opinion (27 F. 4th 1138, 2022, in Mann , and the opinion of the Tax Court in Green Valley (159 T.C. No. 5, 2022, Green Valley.

The bill incorporates the penalty provisions of sections 6662 and 6664 which contain a strict liability penalty. Thus, even if you can prove that the claimed donation's value is correct the penalty will still apply. The new statute does not excuse what I would call "excess true value", meaning the penalty still applies even if where the taxpayer can prove that the actual FMV of the donation is greater than the statutory limit of 2.5 times.

How does partnership tax accounting work? The cap on the amount of the partnership donation creates a question as to how partnership tax accounting works in that context. Do the rules under the section 704(b) regulations, where it references FMV, mean actual FMV or the capped FMV? Or both? The section 704(b) regulations say tax accounting timing controls book accounting under the "N" rule (reg. section 1.704–1(b)(2)(iv)(n)). Thus, if and when section 170(h)(7) is added to the IRC, changes to the 704(b) regulations would seem to be required.

The potential distortion between book and tax already exists because the IRC says outside basis is reduced by only the tax basis of the donated property and not by its FMV, but the book donation presumably is with respect to the FMV of the donated property; or does the "N" rule's reference to the "federal tax treatment" of the deduction mean that book basis is also only reduced by the tax basis of the property donated? That's unlikely because it would cause an immediate distortion between book capital accounts and the actual post-donation FMV assets of the partnership. Current law does not address this issue because the stated facts of Rev. Rul. 96–11 (1996–1 C.B. 140) avoid both the section 704(c)(1)(B) issue as well as the section 704(d) issue relating to basis for loss limitation purposes. The ruling holds that outside basis is reduced only

by the basis of the donated property. That principle is now incorporated into section 704(d)(3)(B).

Under regulation section 1.1001–2(a)(3), amount realized does not include liabilities incurred on acquisition that are not part of basis of the property. Does this apply to 170(h)(7) if the partnership borrows and the actual fair market value on the property exceeds the amount of liabilities when donated? The potential discontinuity arises because section 1011(b) references FMV whereas the section 170(h)(7) deduction would be 2.5 times the partners' relevant basis in their partnership interests. And so, you can have a bargain sale that would apportion part of the basis of the property to the sale portion and what does this do, if anything, to the partners' relevant basis in their partnership interests?

What if the partners donate their partnership interests to charity instead? That is unlikely as the cash partners are unlikely to have a long-term holding period and so a FMV deduction of property would not be allowed (the sponsor is likely to be the only one with a long-term holding period).

And what of the failure, as noted above, to address whether section 704(c)(1)(B) should seemingly apply in these donation cases? Specifically, left unaddressed by new section 170(h)(7) is what happens if the property donated by the partnership is property contributed by the sponsor to the partnership, so-called section 704(c) property. Many of the issues that arise in this context have been previously discussed, although several decades ago, and remain unaddressed in published guidance today. (See Monte A. Jackel, Glenn E. Dance, and John J. Rooney, 704(c) Article , 1 J. Passthrough Entities 8 (1998).)

The cause of this book-tax conundrum is that section 704(c)(1)(B) seems to be inapplicable to the donation because, it is argued, that statute requires a distribution "directly or indirectly" to another partner and it is asserted by some, probably many, that "indirectly" does not cover the case when the partners are in effect all treated as if the property was first distributed in kind to them and then donated by them to charity. However, the words of a statute, such as "indirectly" in this case, must have some meaning.

See Omnibus Budget Reconciliation Act of 1989, P.L. 101–239, Conference Report, Statement of Managers, H. Rep. No. 101–386, Title VII. This provision added the words "or indirectly," but the explanatory material does not discuss what the term "indirectly" means or why it was added. The provision could be limited to cases when the section 704(c) partner also contributes an entity interest (such as stock in a corporation) and other partnership property is also contributed by another partner to the partnership (or purchased by the partnership) and is then contributed to the corporation and then the stock of the corporation is distributed by the partnership back to the section 704(c) partner. However, this strategy is a well-known section 737 avoidance technique and is addressed in the section 737 regulations. Rather, applying substance over form

would seem to support this recast under current law without an act of Congress although Congressional action would be preferable.

Thus, there's a question of whether the charitable donation of in-kind appreciated property within seven years of its contribution to the partnership by a partner triggers section 704(c)(1)(B) as if the donated property was first distributed to the partners and then donated by them. If it were triggered, book and tax would be equalized. Is this or should this be the case? Could section 704(c)(1)(B) be reconciled with new section 170(h)(7) being silent on this issue?

The IRS certainly could take the administrative position that the donation triggers section 704(c)(1)(B) gain because it's indirectly a distribution to the partners because it's done on their behalf. That administrative position would most certainly be challenged in court, but as tax administrator for the IRC, I thought that was one of the main jobs of the IRS as well as the policymakers at Treasury. But, once again, has new section 170(h)(7) put that to rest?
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